DOW THEORY LETTERS INC.

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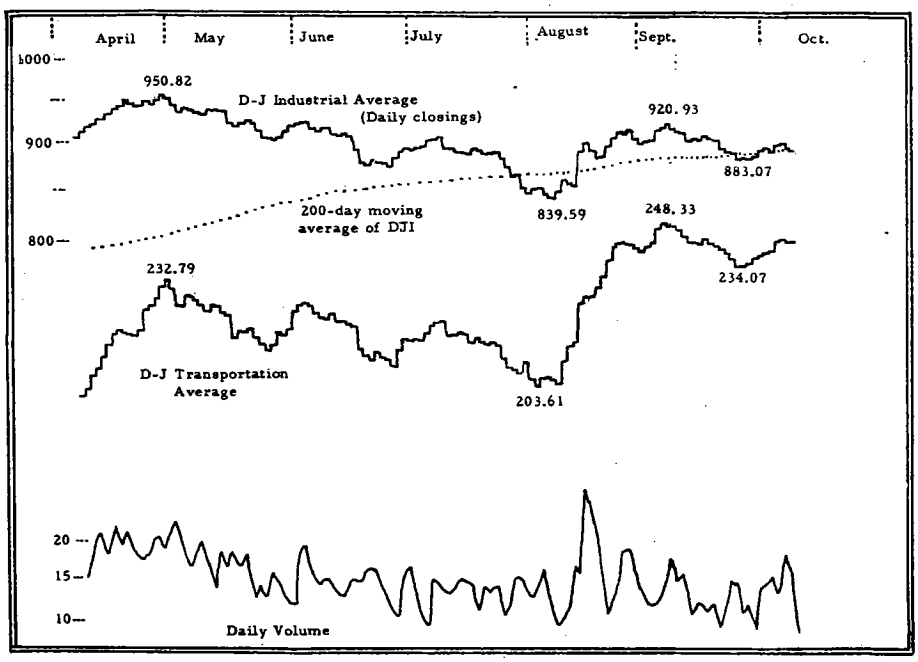
From our "non-surprise of the week dept.": President Nixon asks power to control interest rates and dividends. From our "surprise of the week dept.": U.S. industry operated at only 73.2% of capacity in the third quarter, down from a low 75.1% in the second quarter. "Ominous note of the week dept." Mutual fund net redemptions over purchases in September hit a record $166 million (see Letter 506), for the 4th net deficit month out of the last five.

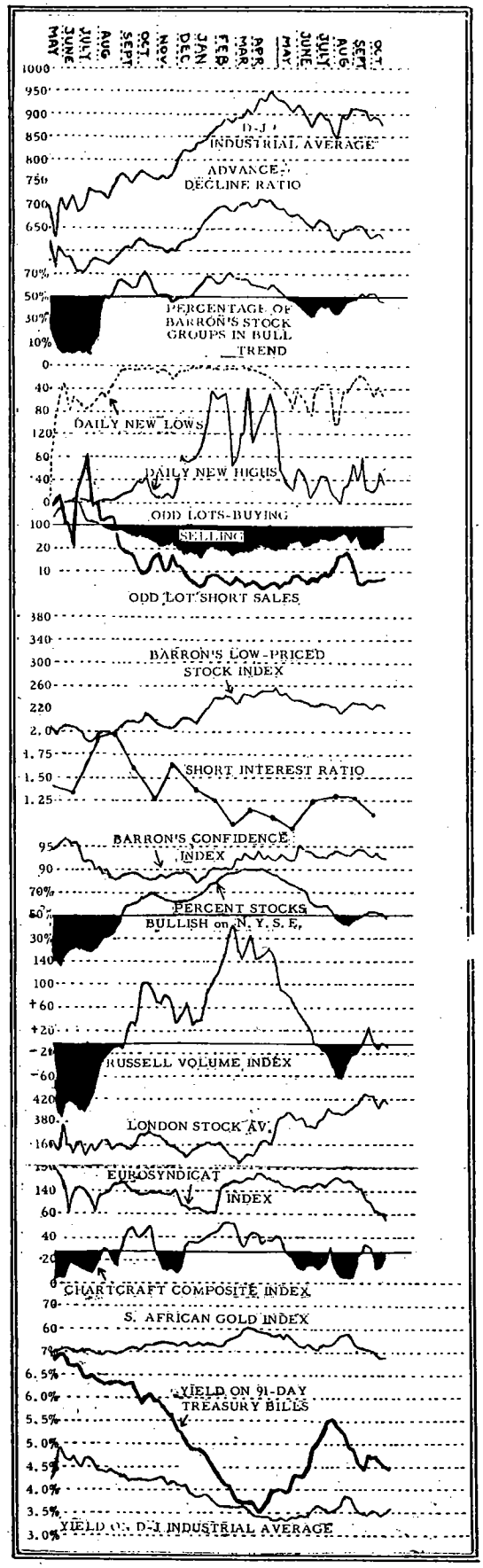
THE MARKET: An analysis of the movements of the Industrial Average for 1971 is rather interesting. The Industrials closed on January 4 (the first trading day of 1971) at 830.57. That figure also represents the low for the year. The high for Industrials occurred four months later, on April 28, at 950.82.

A long decline carried into August 10, at which time the Industrial Average closed at 839.59, just 9 points above the January 4 close. A new rally moved the Dow to a September 8 peak of 920.93, and a second decline then took Industrials back below the 900 level, to last week's low in the 860 area (see page 1 chart).

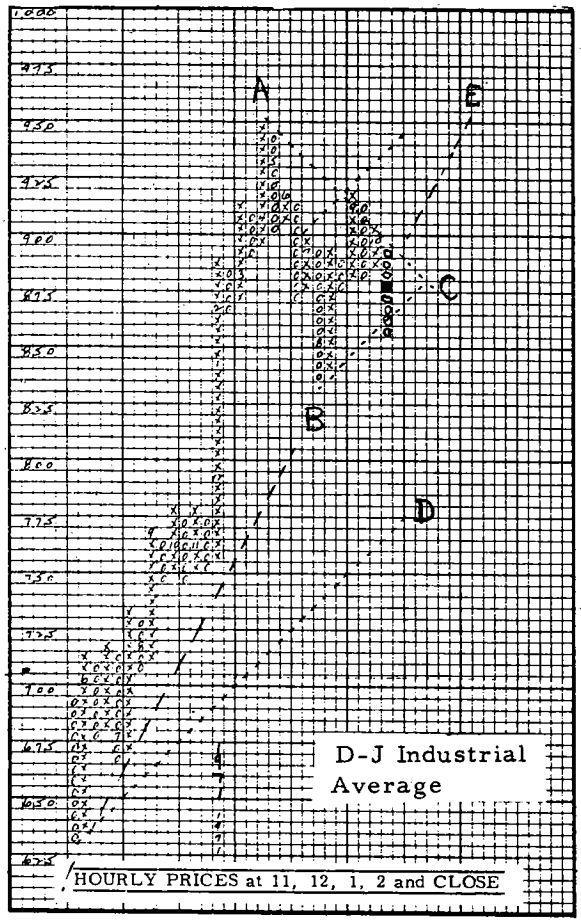
All in all, we see that Industrials have moved through a total range of about 120 points during 1971, with 950.82 the peak and 830.57 the low. As of last week, Industrials were in the bottom third of the year's range, within 35 points of their opening 1971 price.

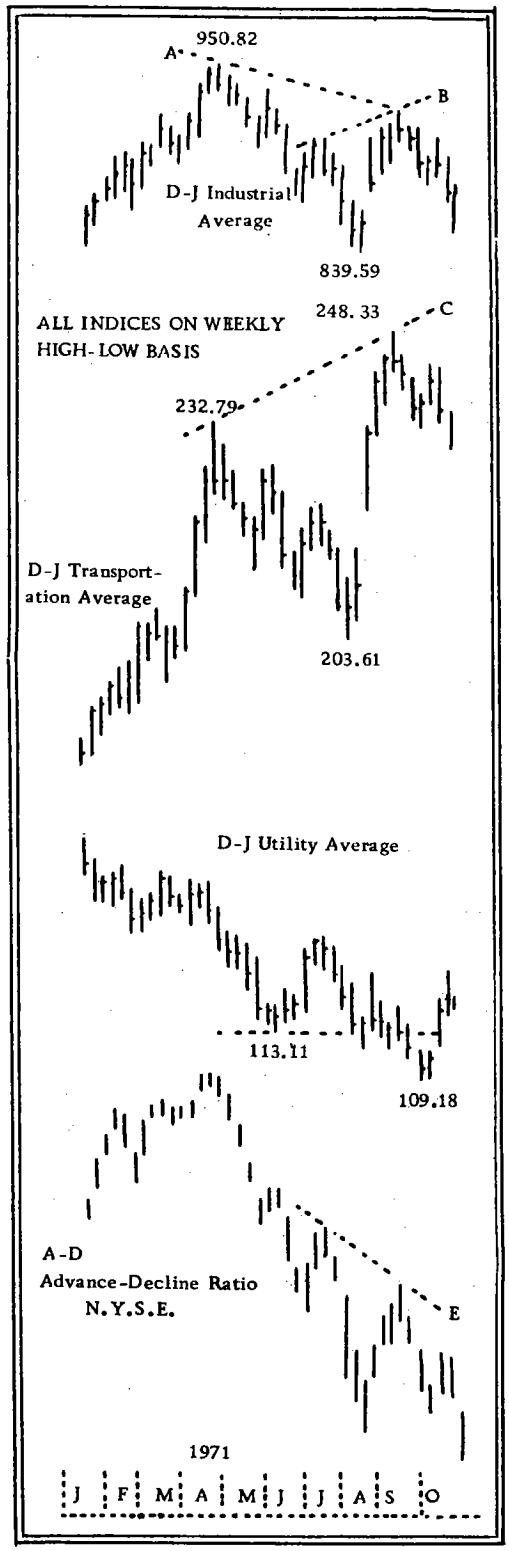
It is also well to remember that from the standpoint of volume, 1971 was a year to remember. There were 24 days in 1971 with volume over 20 million shares (no other year in history even approaches this), and significantly, 20 of those huge volume days occurred with the Industrials above the 870 level (8 of the 20 days occurred with the Dow over the 900 level). This means to me that the Dow is now sinking into the "below 900 area" with a roof over it created by one of the greatest speculative, high-volume areas in history. Technicians frequently refer to such areas as "overhead supply".





On the narrow page 2 chart it is notable that the Industrials are now dropping through the "gap" which occurred on August 16, amid the frenzy following President Nixon's Phase I announcement. The Transports, which have been holding up rather well, showed their first important indication of weakness on October 20 when they broke below their September 27 level of 234.77. In doing so, they confirmed the down-side penetration by Industrials of their own September low of 883.47 (see page 1 chart). The Industrials broke their own September low on October 14, three trading days before the Transport break.





Thus a bearish signal has been rendered by the Averages as they move down towards a potential testing of the August, 1971, lows. Should the August low of 839.59 (Industrials) and 203.61 (Transports) be violated during coming weeks, I would say that the technical picture was bordering on the disastrous.

The advance-decline line, one of the weakest segments of the market, had already signalled trouble (see previous Letters) by refusing to better its July peak, a phenomenon which gave rise to the divergent trendlines B (Industrials) and E (A-D ratio) on the chart. Currently, the A-D ratio is flirting with its August low for the year, and a penetration of that low would, I feel, be ominously bearish for the market (since it would allow for an Industrials confirmation and penetration of their own August low of 839.59).

Finally, we have the Utility Average which has been weak all along and only recently has rallied from its September 27 low for the year at 109.18. Since the collapsing Utility Average has been overdue for a rally, I cannot attach too much importance to its first upward push from the September low.

At this point I want to include a point and figure chart of the Dow Industrials, as I think this may help clarify the big picture. The P & F chart covers the entire 1970-71 advance. This is a 5-point, 15-point reversal chart, which means that every square on the chart equals 5 points on the Dow, and that only rallies or declines of a full 15 points or more are shown on the chart. The X's indicate rallies, the O's indicate declines. (This chart is courtesy of Chartcraft, Larchmont, N.Y.).

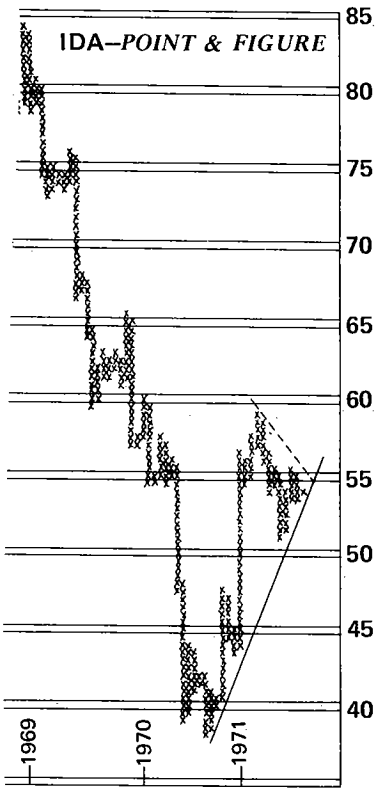
The peak of the Dow rally shows in the 950 box (actually the Dow peak was 950.82). Then we see the series of declines to the 840 box. A second series of rallies carries into September at the 920 box. At this point we can connect trendlines which outline the triangle marked A-B-C. Such triangles frequently possess excellent forecasting signficance.

The most recent decline (the last row of O's) provided the first bearish signal when the Dow (on Oct. 15) touched an hourly 880. This is the point at which the Dow violated its preceding point and figure bottom, and I have marked this point & figure "sell signal" with a solid black box. A second and very powerful sell signal will occur if the Dow breaks below the B-D trendline, a move which would entail an hourly reading of 860 or lower. Such a reading would almost surely mean a testing of the 840 level at B, and I would say that a penetration of the 840 level, if it occurs, could easily set off a broad market panic.

Note that there are two major trendlines marked D and E on the P & F chart. The D trendline is drawn on a 45 degree angle from the 1970 low, and this is the trendline which Chartcraft calls the major bull trendline supporting the entire 1970-71 advance. Many P & F chartists adhere to the 45 degree angle approach, and this method would imply that the entire uptrend is in force as long as the Dow holds above 780 or better. The more orthodox P & F approach (adhered to by such experts as James Dines) holds that trendlines during advances should connect major bottoms. The trendline marked E follows this method, and it is notable that this trendline was cracked when the Dow hit 880, at the exact time when the first bearish signal was given (as described previously). The penetration of trendline E is marked by the solid black box in the 880 square. From the P & F standpoint, the market picture looks bearish. The potential testing of 840 will be the most important single technical event over the period ahead.

It is worth noting that the Dow has now broken below its 200-day moving average for the third time in 1971 (see page 1 chart), once in August, once in September, and once in October.

While every stock market movement has its own individual characteristics, it is worth noting that the third penetration of the 200-day moving average in 1969 was the prelude to the 1969-70 smash. Usually, in stock market history, it is the second down-side penetration of the moving average which is the prelude to a major decline.

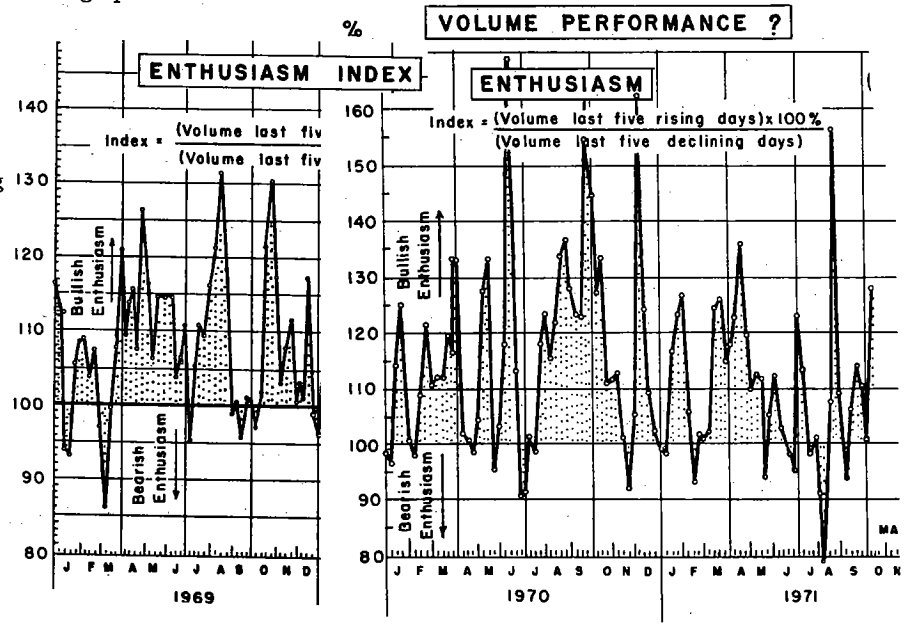


MERCILESS BEAR: I want to discuss a phenomenon which was originally brought out in Letter 476. But first I should mention a remarkable indicator developed by Paul Dysart, Sr. of Trendway. This is what he calls his "negative volume index". The NV index is the plurality of advances over declines or vice versa on days when total Exchange volume is below the preceding day. Over years of study, Mr. Dysart found that "big money" tends to move on receding volume days whereas the "public" tends to move on days when volume is expanding. The NV index has been very successful in indicating the direction of the primary trend. Incidentally, the NV index is now at an historic low.

Actually, the whole Dysart premise is logical. The public tends to buy amid market enthusiasm (rising volume), while big investment money tends to move quietly (receding volume). I always keep this principle in mind, and I find it a great help in gauging major movements.

What I want to do now is document some of the madness of crowds as this primary bear market winds its way towards its ultimate, ominous conclusion. I have included a chart of IDA, the Indicator Digest unweighted average of all N.Y.S.E. stocks. Unlike the Dow Averages, IDA tells what all stocks are doing. The accompanying chart of IDA is a point & figure chart and dates are listed at the bottom. You may be surprised to learn that IDA dropped from $84 in 1969 to a low of $37 in 1970, and that to date it has recorded a 1971 peak of $59. This means that IDA has only recovered about 47% of its 1969-70 losses, and that goes a long way to explaining why the public is currently so icy-cold about the stock market! The fact is the public never approached evening up on their 1969-70 losses.

Nevertheless, here is an amazing fact. From Merrill Analysis (Box 228, Chappaqua, N.Y. 10514) I have borrowed their "Enthusiasm Index." This is the ratio of volume on advancing and declining days. Study the enthusiasm index during the years 1969, 1970 and 1971 to date (these years correspond to the price movement shown on the IDA chart). Despite the fact that IDA has regained only 47% of its horrendous 1969-70 losses, enthusiasm has consistently come in on the upside. In other words, despite one of the most crushing declines in market history, enthusiasm has consistently come into the stock market in the form of rising volume on rallies (as opposed to decreasing volume on declines).



Who was showing all the enthusiasm in the face of the 1969-70 smash and the 1970-71 partial recovery? Personally, and I can't prove it, I believe it was the funds and the pension funds. To that extent, I feel that the funds are now behaving like the odd-lot public of the 1940's and '50's. Despite the fact that the market has been a difficult if not costly affair since 1969, enthusiasm (as gauged by volume) still reigns on Wall Street.

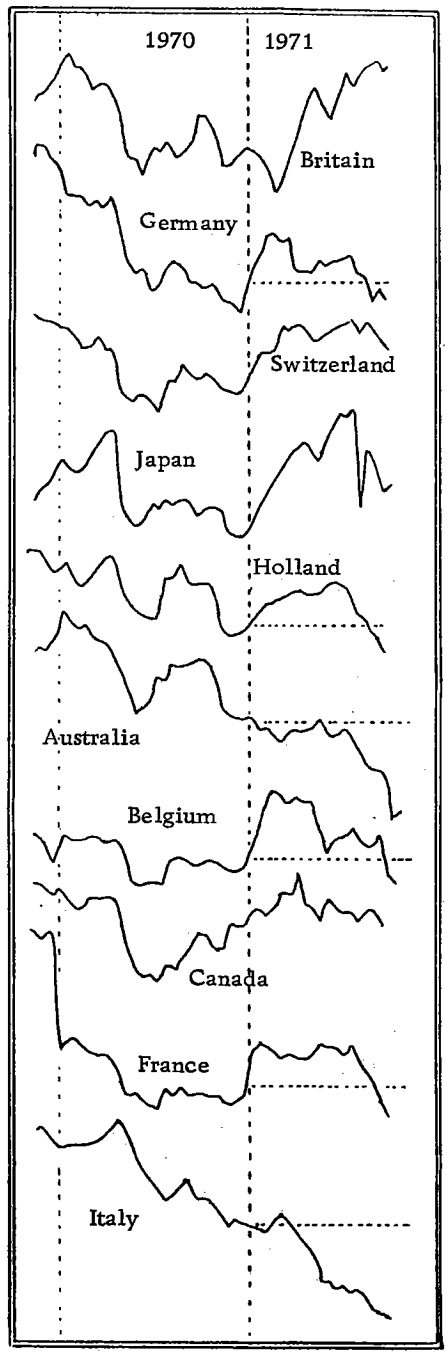
Now here is my conclusion. Before this bear market is over, Mr. Merrill's Enthusiasm Index is going to reverse itself, and the enthusiasm (in the form of selling enthusiasm) is going to come in on the downside. This will mean just the reverse of what has occurred since 1969, it will mean expanding volume on the downside and contracting volume on rallies. When this occurs we will know that the funds are bailing out. The public is out already, and the funds are 94% invested. The final phase of this bear market, it seems to me, will be the one in which the funds, the pension funds and the institutions finally throw in the sponge. Then we may get some record-breaking downside days — perhaps far above the 31 million share record recorded on August 16 (the day after the Nixon speech).

WORLD RECESSION BEGINS: No two primary bear markets are alike, anymore than any two bull markets are alike. Thus, while it is human nature to guard against the major factors which contributed to the last bear market, the "major factors" have an unfortunate habit of changing. For instance, the panic of 1907 was set off by a collapse in the banking system. The Federal Reserve System was put into effect a few years later in an effort to eliminate such a breakdown again. In 1921, however, the bear market was set off by a collapse in the commodity market. In 1929, the smash was triggered by a crumbling of the greatest speculative edifice the world had seen up to that time. Months of investigations, committees and new regulations followed. A few years later the bull market of 1932-37 was set in motion. But in 1937 the violent crash resulted largely from top-heavy inventories and a rush to liquidate. The year 1946 saw an almost purely psychological bear market, brought on because people "knew" that a post-war depression "had to come".

The great bull market which began in 1949 ended in February, 1966. The reason (or many reasons) why the bull market terminated at that time cannot be known at present. Neither do we know exactly why the bear market is taking so long to get its claws unsheathed. And finally, we do not yet know what will set off the violent downward stage of the current bear market, the stage which (I think) will take the Averages far below their 1970 lows.

Among the myriad bearish possibilities, the area which interests me greatly at present is the overseas economic and stock market picture. This is an area which is ignored by most Americans, but I would say that the European and Japanese scene is now more important than ever before. One reason for this is that the combined European-British-Japanese production now competes with the U.S. in terms of size, whereas twenty years ago this was not true.

I include a chart showing the stock averages of ten major trading nations. Note that the right-hand side of the chart (right of the vertical dotted line) includes the year 1971. I have drawn six horizontal dotted lines, each marking the January 1, 1971, level for the following nations: Germany, Netherlands, Australia, Belgium, France and Italy. In each case that nation's stock average is now below the horizontal dotted line, and this means that each of those stock averages is at or near a new low for 1971. Canada is flirting with a new low by a few points. Frankly, I consider a situation where six out of ten major foreign stock averages are at lows for the year to be ominous. It implies that the picture for corporate profits in each of these nations is dim and getting worse; it implies that an international recession is nearing or at hand.



Last week I mentioned that unemployment was heading up around the world, and I noted that England had one million unemployed for the first time, the U.S. has 6% unemployment and Canada has 6.3% unemployment. This week I will add that unemployment is up 20% over last year in Italy, where over one million men are now unemployed. In Holland, France and Sweden, according to this week's U.S. News and World Report (Oct. 18), "Unemployment is a worry...."

Furthermore, corporations are running into trouble. Pirelli, Italy's second largest employer, is trying to lay off a large portion of its work force. Zanussi, huge Italian appliance maker, now has more than a third of its workers on a short week. Maserati, the luxury Italian car builder, has cut its work hours as the U.S. 10% surcharge has hit its orders. Giant Volkswagen of Germany is hovering between the red and the black. Hoechst, massive German chemical concern, saw its profits drop 38% for the first 8 months of 1971. West Germany's bellwether steel industry is now limping with Krupp pensioning workers off early while admitting to sagging orders for steel. Perhaps worst of all, export contracts are said to be off as much as 70% in Japan.

In a personal letter to me received last week, economist Eliot Janeway refers to the "current European panic", and further notes that "As recently as 90 days ago, the Eurodollar market was still going strong enough to offer Japan a fair chance at making up in Europe the export gains no longer available here (in the U.S.). But the alarming break in the European economy has shut off this avenue".

It should be remembered that exports are a large part of the GNP mix in most leading overseas nations. A drop in exports, due to difficulties caused by floating currencies, unstable monetary conditions, and the impact of the 10% surcharge, will cause severe economic slumps in many of the world's trading nations, and that is what seems to be occurring now.

On page 6 I have added another index to the regular gold and silver price chart. This is the Amro-Pierson Average of 50 leading blue-chip corporations in the Free World (it includes some American companies). Note that the Amro Average is now falling rapidly, and it is close to its low of the year of 114.46 (this index is listed in Barron's weekly under foreign stock averages, and I consider it an outstandingly important indicator).

On October 13 Germany made it official that her economy was in trouble by lowering the discount rate to 4.5% from 5% and the Lombard rate from 7.5% to 5.5%. Italy followed suit the same day. German Federal Bank President Klasen warned that the rates were lowered "because the export industry is suffering too much", and he warned that the situation could become "very serious" by 1972.

I include a piece from the October 11 Barron's calling attention to the fact that many U.S. corporations have overseas subsidiaries, and falling profits in these subsidiaries are bound to hurt their total profit picture. This is particularly true of many of the giants represented by the thirty Dow Industrial stocks, and it could be one of the reasons why the Dow has been acting so poorly of late.

On another front, it is worth mentioning that the metal markets are now in severe trouble. This could be one of the reasons for the horrendous drop in silver prices which I have been alluding to in recent Letters. In his latest report, friend Harry Schultz notes that "Silver seems to be pointing the way to global depression". From the October 9 London Economist comes this eye-opener regarding the collapsing metals market.

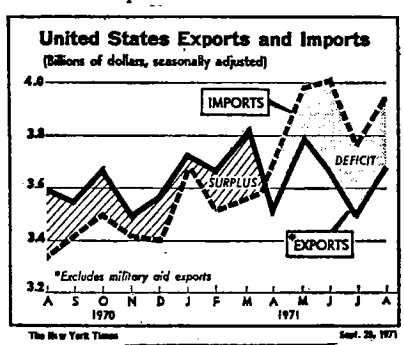
In view of the deteriorating foreign situation, it is most interesting to remember that Treasury Secretary Connally wants to reverse the U.S. payments situation a full $11 billion, from a whopping deficit to an actual surplus. If anything like that occurs, it will mean that overseas nations will suffer terrific damage as the U.S. gains what they lose. To put it mildly, foreign nations can ill afford to lose anything on their exports, but this is what the U.S. is demanding. The accompanying chart shows one reason why the U.S. is frantic regarding the payments picture. Here we see the persistent import-export deficit which has built up since March-April, 1971, a trade deficit that threatens to be the first annual deficit since 1893. This is particularly ominous when we realize that the trade picture has traditionally been the best segment of the entire U.S. payments picture.

The worldwide business recession (Barron's, October 4) **is spreading rapidly. Hardest hit are Japan, Germany and Switzerland. The Alpine republic suffers from a lack of export orders for its manufacturers. In Germany, most major industries are cancelling investment projects and adjusting their operations to waning profits. In Japan, a similar process is under way, aggravated by the drying up of shipbuilding orders in the wake of the shipping slump. All other industrial nations suffer from similar pressures. Such tendencies cannot, of course, fail to hurt the overseas subsidiaries of U.S. concerns, and next year they will show up in corporate income statements. Official American policy is based on the assumption that the nation could cut its imports while boosting exports and creating new jobs. Nothing seems less likely; impoverished and resentful customers, even if their governments fail to resort to open retaliation against the U.S., will not offer profitable markets to U.S. industry and agriculture. As the world's prosperity wanes, American business cannot hope to escape.**

Metals

Down, down, down

World metal prices have slithered to their lowest levels for four years. The collapse since the initial signs of a recession appeared early in 1970 has been startling. Copper has fallen by almost 40 per cent, lead by 30 per cent, the free price of nickel has plummeted from a strikebound high of £7,000 a ton to £1,100. These metals account for the largest unit of world trade after oil. Their price collapse has shifted the balance of trade in favour of the industrial nations, widening the gap between the rich countries that consume resources and the poorer nations that produce them.



All I can say in concluding this section is that subscribers should keep their eyes glued to the overseas picture. This is where trouble is brewing and brewing fast.

STOCKS: Under my interpretation of Dow Theory, buying stocks during a primary bear market is tantamount to spinning the wheel at Las Vegas. Nobody says you can't come away with more than you arrived with, but the instances are rare and far between. Furthermore, you may "hit it" at Vegas once or twice, but try coming out ahead over say a three-year period.

Bear market's are made to correct, to squeeze the water out of inflated or bloated economies. During the process values are vastly reduced. Before a major bear market is over, almost everyone has losses. The majority of the shrewdest investors usually "lose just a little" before the bear market is over. This is the reason I do not recommend stocks during a primary bear market. When I do refer to stocks, it is usually because those stocks have some bearing on the overall market or economic picture.

One such issue is American Telephone (the world's most widely held stock). What happens to Telephone's half billion shares outstanding tends to affect the entire stock holding population of the U.S. It is that widely held. Note on this monthly chart from M.C. Horsey (Salisbury, Md. 21801) that it is flirting with an all-year low. Since 1960 T has formed an immense "head-and-shoulders" type distribution pattern, and the resistance of "neckline" at 50 now seems to have formed a long-term roof over the stock.

In time, I believe we will see T break below 40, and this will constitute a horrific downside penetration of the 1970 low. Such action will mean that millions of T stockholders will be locked in with even worse losses than is now the case, and it will also mean $billions in lost market values for this most widely distributed issue.

LATE NOTES: At the close, Oct. 20, the A-D ratio broke below the August low, a very bearish turn of events (see page 2). At the same time the Dow hit the 860 level on the point & figure chart (page 2) thereby breaking out of the A-B-C triangle and setting off a very important "sell signal". It is, I feel, significant that the market broke badly on October 20 in the face of the news of prime rate cuts. A market which sells off on supposedly bullish news is a market that wants to go down with a vengeance.

In closing I want to say "my very best" to Dr. Harry Schultz and all the gang at the Bermuda meeting of the International Investment Letter Assoc. (of which I am an officer). It should be a fantastic affair and those who attend should receive some fabulous information and have met some great people (including the Ulysses of the investment world, Dr. Schultz himself). I am sorry I cannot attend, but fate has me glued to San Diego.

LATE LATE NOTE: On Oct. 20 Lockheed announced that the British had dropped orders for 29 Tristar superjets, lowering the total of orders for Tristars from 178 to 149. Meanwhile, the breakeven point on the Tristar has been raised upwards above 250. Thus, despite the $250 million Government loan, the Lockheed story appears to this observer to be more ominous than ever.